

**PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE**

February 7, 2016
Report No.: 112667

Operation Name	Bosnia and Herzegovina: Public Finances DPF
Region	EUROPE AND CENTRAL ASIA
Country	Bosnia and Herzegovina
Sector	Other Public Administration (40%); Central Government (Central Agencies) (30%); Sub-National Government (30%)
Operation ID	P149768
Lending Instrument	Development Policy Lending
Borrower(s)	BOSNIA AND HERZEGOVINA
Implementing Agency	
Date PID Prepared	December 12, 2016
Estimated Date of Appraisal	January 27, 2017
Estimated Date of Board Approval	March 23, 2017
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.

I. Country and Sector Background

Since the global financial crisis of 2008, economic growth in Bosnia and Herzegovina (BiH) has slowed and along with it, the rate of convergence to EU income levels. Following a double-dip contraction of the economy between 2008 and 2012, the country experienced the beginning of a moderate economic recovery in 2013 when growth reached 2.4 percent. This was interrupted by the floods of May 2014 which impacted almost all sectors of the economy and slowed growth to 1.1 percent in 2014. As a result of these dynamics, annual growth averaged only 0.9 percent in the period 2009-2016 and since 2008 average income per capita on a PPP basis has remained stagnant relative to the EU average at 26-27 percent

The slow growth exposed also weaknesses in public finances in BiH. While the country's fiscal deficits and public debt levels have been moderate (annual average of 1.8 percent of GDP and 34 percent of GDP, respectively, in 2008-2016), BiH faces challenges of inefficiencies and lack of transparency in its public finances. BiH has one of the world's largest public sectors relative to the size of its economy, with general government expenditures at 43.7 percent of GDP in 2016 and public enterprises adding even more to the overall government footprint on the economy. Pensions, social transfers, and public wages together amount to nearly a third of GDP and are the main causes for the excessive level of recurrent spending. Social transfers are poorly targeted and embody poor incentives with respect to informality and labor force participation. Not only is public spending structurally high and unproductive, but importantly the quality of and control of spending is weak, leading to inefficient use of public resources and crowding out of private ones. Weaknesses in fiscal reporting system at all levels of government and failure to recognize (and resolve) public arrears, whose size and type remain undocumented, is interfering

with prudent public financial management. Fiscal risks stem from the weak links among public investment, debt management, and medium-term budgeting as well as from the presence of public arrears.

This proposed DPL utilizes an opportunity to advance reforms in the area of fiscal policy. After years of policy stagnation, there is a new shared understanding at all levels of government of the imperative to move forward with structural reforms. The BiH Council of Ministers and the entity-level governments (Federation of Bosnia and Herzegovina (FBiH) and Republika Srpska (RS)) officially endorsed a medium-term Reform Agenda in July 2015, which serves as a blueprint of structural reforms. The BiH's Reform Agenda aims to foster economic growth, create jobs, and improve the efficiency of social assistance, while setting a path towards fiscal consolidation and preserving macroeconomic stability. Detailed time-bound action plans have been subsequently developed and are being implemented at all levels of government and with the support of international partners. In February 2016, BiH submitted its EU membership application. Most recently, after much discussion, in August 2016 agreement has been reached on the adaptation of the trade provisions of the BiH-EU Stabilization and Accession Agreement and on putting in place an EU Coordination Mechanism.

II. Operation Objectives

The proposed Public Finances Development Policy Loan (DPL) of USD 80 million directly supports the policy efforts of the government of Bosnia and Herzegovina (BiH) to improve transparency of public finances and contain fiscal pressures in BiH. The operation is anchored to the reforms envisioned under the Public Finance part of the government's Reform Agenda, which focuses on fostering fiscal sustainability through decreasing public debt, while creating room for public investment and reducing the size of the public sector in the economy.

This stand-alone DPL is structured around two pillars:

- i. Under Pillar I, the DPL aims to strengthen the medium-term management of public assets and liabilities for improved transparency of public finances.** Fostering the links and complementarities of reforms related to medium-term debt management and public investment management as well as documentation (and eventual clearance) of public arrears are among the policy measures through which the objective of Pillar I is to be achieved. Prior actions under Pillar I include: (i) The Council of Ministers and the entity governments of FBiH and RS each adopt their respective Public Investment Program 2016-2018; (ii) Entity governments of FBiH and RS and BiH Council of Ministers each adopt Medium Term Debt Strategy; (iii) FBiH MoF introduces reporting requirements on arrears for budget users in the FBiH; and (iv) RS government introduces reporting requirement on health sector arrears.
- ii. Under Pillar II, the DPL seeks to strengthen select regulatory frameworks with fiscal implications to contain fiscal pressures** by addressing structural challenges in pensions, public employment and public enterprises through reforms of the labor law, bankruptcy procedures, and pricing of pharmaceutical. Prior actions under Pillar II

include: (i) FBiH and RS entity-level Parliaments adopt changes to the labor law to cease the validity of the current collective bargaining agreements and limit the duration of new collective agreements to three years; (ii) FBiH and RS entity-level Parliaments adopt changes to the labor legislation to introduce a maximum level of severance payments; (iii) RS Parliament adopts and FBiH Government approves amendments to the insolvency legislation aligned with international best practice; (iv) FBiH Parliament adopts the Pension and Disability Insurance Law, introducing pension point formula with clear valorization and indexation patterns, as well as tightening early retirement, disability, and survivorship criteria, and (v) BiH Council of Ministers approves the updated Rulebook on the regulation of maximum wholesale prices for medicines.

III. Rationale for Bank Involvement

The proposed DPL is closely linked to the envisioned outcomes of the CPF 2016-2020 and the WBG twin goals of poverty reduction and boosting shared prosperity. Focus area I of the CPF supports the increase of public sector efficiency and effectiveness. It aims to support BiH in strengthening fiscal sustainability, reforming the state-owned enterprises' role in the economy, and improving public service delivery (such as health, water supply and sanitation). This DPL, the on-going technical assistance on pension reform and debt management, the planned work on SOEs as well as the preparation of projects in the health sector (RS) and on financial management and control in the public sector complement each other to achieving the envisioned outcomes of the CPF. In addition, the planned study on the distributional impact of fiscal policy will shed light on the equity aspect of reforms, closely related to this proposed DPL.

This proposed DPL will also complement the IMF's three-year Extended Fund Facility (EFF) of USD 608 million approved in September 2016 to support BiH's reform agenda.

IV. Tentative financing

Source:	(\$m.)
Borrower	0.00
International Bank for Reconstruction and Development Borrower/Recipient IBRD	80.00
Others (specify)	
	Total 80.00

V. Tranches *(not applicable)*

VI. Institutional and Implementation Arrangements

The World Bank continues to work in close cooperation with the government of BiH to monitor and assess the implementation of the reform agenda supported by this DPL. The

BiH Council of Ministers as well as RS and FBiH Ministries of Finance will be responsible for implementation of the proposed operation and for coordinating actions among other concerned ministries and agencies in their jurisdictions. The Ministry of Finance and Treasury of the BiH will perform the overall monitoring and evaluation of the implementation of this operation. The Ministry of Finance and Treasury BiH will track the targeted result indicators based on the economic and legislative data provided by the government agencies and disclosed in the official sources.

VII. Risks and Risk Mitigation

The overall risk to the operation is substantial. Complex governance structures, frequent political tensions and a weak track record in implementing structural reforms all pose a risk to this operation. BiH's decentralized governance structure complicates coordinated preparation and implementation of development strategies and programs. An important mitigating factor is that the different level of governments have achieved a broad-based unprecedented level of agreement behind the Reform Agenda document. The society at large has been engaged through consultations and is supportive of the content of key reforms related to labor, pensions, bankruptcies, and strengthening of the public administration. The support of the BiH reform efforts from the international community is another important mitigating factor of these risks.

In addition, there are risks related to the macroeconomic outlook, stemming from the external environment (in particular, in the Euro area) as well as the domestic environment (related to the realization of contingent liabilities and in particular arrears). A prudent macro-fiscal medium term framework combined with growth-enhancing structural reforms, including the ones supported by this operation, and significant financial support from the World Bank, the IMF and the EU are likely to mitigate the macroeconomic risks. This medium-term framework is anchored by the three-year Extended Fund Facility IMF program, approved in September 2016.

VIII. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

The reforms supported under the proposed operation are expected to be beneficial to poverty reduction and shared prosperity over the medium term. Policies aimed at strengthening the links between medium-term fiscal planning, medium-term public investment management, medium-term debt management, and arrears recognition should improve the government's ability to manage risks, and improve its capacity to link public resources with strategic development goals. These reforms should also lead to better measurement of the impact of spending and, over the medium term, should translate into improved service delivery for all, including the bottom forty percent and those socially excluded. Reforms related to reforming the labor regulations as well as those facilitating market exit of non-viable enterprises are expected to be beneficial to job creation. Pension reforms supported by the DPL should lead to improvements in the welfare of both the pensioners and younger cohorts, as well as incentivizing greater labor market participation, including among women. The reforms aimed at improving the

efficiency of pharmaceutical procurement would benefit all households through lower prices and greater availability of medicines.

Environment Aspects

Overall the reform policies supported by the DPL is not likely to have adverse effect on the environment, forests and natural resources. The policy measures focus on legal, regulatory, and supervisory reforms to strengthen public finance, with no impact on the environment.

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